
STATE OF INDIANA

DEPARTMENT OF LOCAL GOVERNMENT FINANCE



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Overview of the Income Approach to Valuation

Income Approach to Value: The income approach to value is one of three generally accepted appraisal methods used to determine market value appraisals. The others are the cost approach and the sales comparison approach – each is based on economic principles that emulate the marketplace.

Applying the Income Approach in Indiana: All three approaches are used in the appraisal or assessment of real property in Indiana's market-value-in-use system. This year, nearly all counties have used the cost approach initially because of the availability of data. These values have been compared to sales in the equalization process. The sales approach is most applicable to those properties, such as residential properties, that are bought and sold regularly in the open market. The income approach is most applicable to properties that are leased and held for investment, such as apartments, shopping centers, warehouses, and office buildings. Appraiser must extract the income-related data from the marketplace and apply it only to comparable investment real estate. Assessing officials can also consider income evidence in appeals. Since the income approach measures the actions of buyers and sellers in the marketplace, the resulting value from a properly applied income approach will be substantially the same as a properly applied cost approach or comparable sales approach.

Determining Value under the Income Approach: There are more refined capitalization formulas depending on how investors look at the return on real estate investments; however, this is the simplest income approach formula:

$$\text{net operating income} \div \text{capitalization rate} = \text{market value of the property}$$

Estimating Income: Gross income is the rent a property can produce for the owner in a given time span, generally one year. The appraiser looks at comparable marketplace rentals to determine the applicable rent for the property – this may not be actual rent. For example, the rent paid for properties encumbered by old long-term leases or between related entities are not economic (market) rentals. The income estimate is adjusted for vacancy and debt collection losses.

Deducting Expenses: Appraisers then deduct expenses typical to the property-type being appraised. The actual income and expense statements are examined and adjustments made based on appraisal practices. Adjustments may include annualizing irregular expenses, stabilizing atypical expenditures by comparing to industry norms, and adding a replacement reserve to expense long-lived items. Real estate taxes are not considered since taxes are calculated on final value estimates rather than pre-revaluation value. Net operating income is not the income produced from the sale or manufacture of goods or services on the property.

Capitalization: An investor's main objective is to make money on the dollars invested. Money is made in periodic income such as interest, dividends, or in the case of real estate, rent. Additional return comes from growth or capital gain from the sale of the investment. In real estate, there is appreciation or depreciation over the life of the investment and increasing equity resulting from paying off the mortgage. An investor also attempts to minimize the risk of losing the dollars invested; therefore, the principle of substitution affects setting the value. Under the income approach, the substitution principle provides that a buyer will pay no more for the property than it would cost them to purchase an equally desirable, substitute investment that offers the same return and risk as the property.

Capitalization Rate: Capitalization is the mathematical process used to convert income into value. The capitalization rate is extracted from the marketplace using detailed income and expense information on sold properties. The overall rate may also be calculated by equations that measure safety or risk, liquidity, investment size, using equity as collateral for other investments, leverage, holding period, amount of management required, potential for appreciation and income tax advantages. An effective tax rate is added to the capitalization rate to account for the expense of property taxes on the real estate.